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REPORT
No. 97-643

NORMALIZATION METHOD FOR PUBLIC UTILITY PROPERTY

REPORT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ON

H.R. 1524

together with

ADDITIONAL VIEWS

[Together with cost estimate of the Congressional Budget Office]

SEPTEMBER 30 (legislative day, SEPTEMBER 8), 1982.—Ordered to be printed

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SEPTEMBER 30 (legislative day, SEPTEMBER 8), 1982.—Ordered to be printed

Mr. DOLE, from the Committee on Finance, submitted the following

REPORT

together with

ADDITIONAL VIEWS

[To accompany H.R. 1524]

[Together with cost estimate of the Congressional Budget Office]

The Committee on Finance, to which was referred the bill (H.R. 1524) to amend sections 46(f) and 167(l) of the Internal Revenue Code of 1954 with respect to the treatment of public utility property, having considered the same, reports favorably thereon with amendments, and an amendment to the title, and recommends that the bill as amended do pass.

The amendments are shown in the text of the bill, as reported, in italic.

I. SUMMARY

Normalization Method for Public Utility Property

Present law

For property placed in service after 1980, public utilities generally are allowed the investment credit and accelerated cost recovery only if the benefits of the investment credit and accelerated cost recovery are normalized for ratemaking purposes. For property placed in service before 1981, similar rules apply to investment credits and accelerated depreciation, but certain companies are exempted from the normalization requirement. Normalization generally requires that tax benefits be taken into account for ratemaking purposes over the service life of the asset that generates the tax benefits.

Subject to certain "grandfather" exceptions, normalization rules for accelerated depreciation were imposed in 1969. Subject to the same gen-

eral grandfather exceptions, normalization rules for the investment credit were imposed in 1971. Except as provided in certain transition rules, the normalization rules were made mandatory and more comprehensive for property placed in service after 1980.

Explanation of provisions

The bill restates and makes more specific the normalization rules relating to the investment credit, accelerated depreciation, and accelerated cost recovery. The bill also gives the Treasury Department specific authority to provide regulations setting forth conditions under which ratemaking projections and adjustments are not treated as consistent with the normalization rules. The amendments generally apply to taxable years beginning after December 31, 1979.

The bill also provides a special transition rule. Under the special rule, a ratemaking projection or adjustment that violated the normalization requirements will not result in a public utility's loss of eligibility for the investment credit or accelerated depreciation if the projection or adjustment (1) applied for a period ending before March 1, 1980, (2) was included in an order entered by a public service or public utility commission before March 13, 1980, and (3) was used to determine the amounts of rates which were ordered to be collected or refunds which were ordered to be made.

The special transition rule is designed to benefit Pacific Telephone and Telegraph Company (a subsidiary of American Telephone and Telegraph), General Telephone Company of California (a subsidiary of General Telephone & Electronics Corporation), and Southern California Gas Company.

These provisions of the bill are the same as in the House-passed bill (H.R. 1524).

Charitable Contributions of Certain Items Created by the Taxpayer

Present law

Under present law, the amount of charitable deduction otherwise allowable for donated property generally must be reduced by the amount of any ordinary income which the donor would have realized had the property been sold for its fair market value at the date of the contribution (sec. 170(e)). Accordingly, an artist, author, composer, etc., who donates works of art, books, letters, etc., which he or she created is allowed a charitable deduction in the amount of his or her basis in the donated property, which typically equals the cost of the materials used in the creation of the works.

Explanation of provisions

Under the bill, the amount of charitable deduction for a contribution made after 1982 of any literary, musical, or artistic composition, letter or memorandum, or similar property is the property's fair market value on the date of contribution if the donated property was created by the personal efforts of the taxpayer making the contribution, and if certain requirements are satisfied relating to use of the donated property by the donee and receipt of a written appraisal of the property's fair market value. (This special deduction rule will not apply to contributions of any letter, memorandum, or similar property which

was written, prepared, or produced by or for any government official or employee if such property arose out of, or was related to, the performance of that individual's duties.) Also, the bill provides that any amount deductible under the regular income tax as a result of the special charitable deduction rule added by the bill is not deductible under the alternative minimum tax for individuals.

The House-passed bill did not contain these provisions.

Decrease in Holding Period Required for Long-Term Capital Gain Treatment

The bill reduces from one year to six months the holding period for determining whether a gain or loss on the sale or exchange of a capital asset (or certain business property) is long-term or short-term. This provision generally applies to sales or exchanges made after June 30, 1982, except that the new holding period does not apply to assets held by the taxpayer on that date on which the taxpayer realizes capital losses.

The bill also includes provisions relating to the tax treatment of straddles in stock options and the tax treatment of gain from the cutting of timber.

The House-passed bill did not contain these provisions.

II. EXPLANATION OF THE BILL

A. Normalization Method for Public Utility Property (sec. 1 of the bill and secs. 46(f), 167(l), and 168(e) of the Code)

Present Law

In general

Generally, utility regulatory commissions allow a utility to charge customers so that the utility can collect enough revenues to cover its cost of service. The cost of service includes annual operating expenses and annual capital expenses. Operating expenses include expenses such as labor, fuel, State and local taxes, and Federal income taxes. Capital expenses include an annual depreciation charge for operating assets and a rate of return on the utility's rate base (the basis of its operating assets).

Accelerated depreciation methods, accelerated cost recovery, and investment credits were enacted to encourage higher rates of investment in new and replacement property. By reducing the initial cost of equipment or permitting a more rapid recovery of capital, these investment incentives increase the estimated after-tax rate of return from the asset.

For investment in public utility property, there are two general ways a utility regulatory commission can account for the benefits of accelerated depreciation, accelerated cost recovery, and investment credits in setting utility rates. One way, flow-through accounting, treats these benefits as a current reduction in Federal income tax expense. Thus, current operating expenses are reduced and the benefit is flowed through to the current utility customers. A second way, normalization accounting, treats these benefits as a reduction in capital expenses. As a reduction in capital expense, the benefits are still flowed through to customers. However, because the benefits are flowed through as reduced depreciation charges or returns on a reduced rate base, they are flowed through to customers over the service life of the asset that generated the tax benefit or the period for which tax is deferred. Thus, under normalization accounting, the benefit of reduced capital expenses for a specific capital investment is enjoyed by all the utility customers who pay the capital expenses of the investment.

Accelerated depreciation and accelerated cost recovery

When accelerated depreciation was provided under the 1954 Code, there were no special provisions relating to the ratemaking treatment of accelerated depreciation for regulated utilities. The stated congressional intent was to stimulate the economy by fostering capital formation. However, because Federal income tax expense represents an element of cost of service for ratemaking purposes, some regulatory agencies treated the reduction in current tax liability resulting from accelerated depreciation as a current reduction in cost of service and

therefore flowed it through to customers currently as lower rates. This practice, which is known as "flow-through" ratemaking, meant that accelerated depreciation would provide no investment incentive except to the extent that lower rates increased consumer demand and created the need for additional capacity.

In response to what the Congress saw as an undesirable trend toward flow-through ratemaking, Code section 167 was amended as part of the Tax Reform Act of 1969. Under Code section 167(l), a utility which had not previously used accelerated depreciation for Federal tax purposes could thereafter use accelerated depreciation only (1) if the utility used a "normalization" method of accounting in its books of account and (2) if the regulatory agency used a normalization method of setting rates.[1]

Code section 167(l)(3)(G) provides that:

> "In order to use a normalization method of accounting with respect to any public utility property—
>
> "(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and
>
> "(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation."

The Treasury Regulations (§ 1.167(l)–1(h)) interpret this section defining normalization to require that: (1) a utility's tax expense for ratemaking purposes must be computed as though straight-line depreciation were being used for tax purposes; (2) the full amount of the deferred taxes (i.e., the difference between tax expense computed first using accelerated and then using straight-line depreciation) must be reflected in a reserve and thus be available for capital investment; and (3) the regulatory agency may not exclude from the rate base an amount greater than the amount of the reserve for the period used in determining the tax expense as part of the cost of service. The Treasury Regulations (§ 1.167(a)–11(b)(6)) also interpret section 167(l) as requiring that, in addition to the benefits of accelerated methods of depreciation, some or all of the benefits of shortened useful lives under the ADR system must be normalized.

Thus, a normalization method of accounting results in the benefits of the tax deferrals from accelerated depreciation being reflected in

[1] In general, these rules apply to public utility property used in a public utility activity. Property is public utility property if, during any period, it is used predominantly in a public utility activity. Public utility activities to which the depreciation method limitations apply means the trade or business of furnishing or selling:

(1) Electrical energy, water, or sewage disposal services;
(2) Gas or steam through a local distribution system;
(3) Telephone services;
(4) Other communication services (whether or not telephone services) if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701); or
(5) Transportation of gas or steam by pipeline, if the rates (for the furnishing or sale) are established or approved by certain regulatory bodies.

the rates charged to customers as a reduction in capital expenses over the period of tax deferral.

By allowing utilities to use accelerated depreciation only if normalization were followed, the Congress had two principal objectives: first, to assure that the deferred taxes derived from accelerated depreciation would be available to the utilities as investment capital until paid to the Treasury; second, to avoid the additional loss of Federal tax revenues that it believed would result because flow-through ratemaking would reduce utility profits.

When the Congress enacted the accelerated cost recovery system (ACRS) in the Economic Recovery Tax Act of 1981 (ERTA), it decided that the full benefits of ACRS should be normalized by all public utilities. Therefore, except as provided in a special transition rule for rate orders issued before enactment of ERTA, all public utilities are required to normalize the tax benefits of ACRS accelerated depreciation, shortened useful lives, salvage value rules, and placed-in-service averaging conventions.

Investment tax credit

When the Congress restored the investment tax credit in 1971, it provided that the investment tax credit for public utility property generally would not be available if the credit was flowed through to utility customers at a rate faster than that permitted under one of two optional normalization rules. However, utilities permitted to use flow-through accounting for the benefits of accelerated depreciation under the grandfather rules of the Tax Reform Act of 1969 were also permitted to use flow-through accounting for the investment tax credit if they made an affirmative election. In the Revenue Act of 1975, the Congress increased the amount of the credit for public utility property that could be used to offset tax liability and increased the amount of the credit for public utility property from 4 percent to 10 percent. For this additional credit, flow-through accounting was not permitted to the grandfathered utilities unless the utility made a new affirmative election.

When the Congress revised the investment tax credit provisions in the Economic Recovery Tax Act of 1981, it generally repealed the flow-through exception for all property placed in service after 1980. Thus, except as provided in a transition rule for rate orders issued before enactment of ERTA, all public utilities must use one of two normalization methods to account for investment credits for public utility property placed in service after 1980.

The two optional normalization rules of section 46(f) are known as the rate base reduction rule and the ratable flow-through rule. Both of these normalization rules permit some of the benefit of the investment tax credit to be flowed-through to utility customers as a reduction in capital expense. Taxpayers generally are subject to the rate base reduction rule unless they made an election in 1972 to be subject to the ratable flow-through rule or, if eligible, made an election to use flow-through accounting. For a limited group of utilities, gas pipeline companies, a special election also was available in 1972 that prohibited any flow-through of the credit, either as a reduction in current operating expense or a reduction in capital expense over the service life of the qualifying property.

Under the rate base reduction rule, some of the benefits of the investment tax credit may be flowed through to utility customers as a reduction in capital expense by excluding the credit from the utility's rate base. In this way, the utility customers are not required to pay a rate of return to the utility on the part of the cost of equipment that was paid for, in effect, by the investment tax credit. However, under this rule, no other adjustment may be made to the operating expenses or capital expenses included in the utility's cost of service. Thus, no adjustment is permitted to be made, by reason of the credit, to the utility's Federal income tax expense or depreciation allowance included in its cost of service. The utility, therefore, is allowed to retain the use of the credit as capital and is allowed to include in its cost of service a depreciation allowance for the part of the equipment cost paid for, in effect, by the investment credit.

Under the ratable flow-through rule, the benefits of the investment tax credit may be shared with utility customers by denying any depreciation allowance in the utility's cost of service for the part of the equipment cost that was paid for, in effect, by the investment credit. Under this rule, no additional adjustment may be made by reason of the credit to the utility's operating expenses or capital expenses included in its cost of service. The utility, therefore, is allowed to retain the use of the credit as capital and is allowed to include in its cost of service a rate of return on the part of equipment cost paid for, in effect, by the investment credit.

Projections, estimates, and adjustments

The application of the depreciation and investment tax credit normalization rules has generated considerable controversy and uncertainty, due in part to the nature of the ratemaking process. In setting utility rates, it is customary to use a "test period" as a surrogate for the period when utility rates will actually be collected. Based on the experience of the test period (investment levels, operating expenses, etc.) appropriate rates are established. In some jurisdictions, adjustments are made to the test period experience to reflect expected changes in the future relationships between investments, expenses, and revenues. An example of such an adjustment would be a change in the Federal income tax rate to take effect after the close of the test period.

The proper application of the normalization rules with respect to the use of adjustments, estimates, and projections has been especially controversial in California. Prior to 1969, the California Public Utilities Commission generally required utilities under its jurisdiction to flow through the tax benefits of accelerated depreciation to customers immediately. However, in accordance with Code provisions making the use of accelerated depreciation elective, Pacific Telephone and Telegraph Company and General Telephone Company of California, the telephone companies under the Commission's jurisdiction, did not elect to take accelerated depreciation for Federal tax purposes. In a 1968 decision, the Commission found that it was imprudent for the companies to use straight-line depreciation for Federal tax purposes, and the Commission set rates as if accelerated depreciation had been elected and flowed through the tax benefits of this imputed accelerated depreciation to the customers. This 1968 decision was modified by the Commission in 1970 to allow the companies to elect accelerated depreciation

with normalization as prescribed by the Code. However, in 1971 the California Supreme Court annulled the 1970 decision on the grounds that (1) the 1968 decision did not have to be modified because of the intervening passage of the Tax Reform Act of 1969 rules requiring that public utilities (other than public utilities which had previously used accelerated depreciation and flowed it through to their customers) could elect accelerated depreciation only if the benefits of such depreciation were normalized and (2) other methods of normalization should have been considered.

After protracted litigation (including three more decisions of the California Supreme Court and two unsuccessful petitions for certiorari to the U.S. Supreme Court), the Commission entered an order which requires the telephone companies to use certain methods of accounting to measure the amount of the benefits from accelerated depreciation and the investment credit that are to be shared with the utility customers.

The Internal Revenue Service has issued private letter rulings that take the position that these methods do not comply with the normalization requirements. The IRS has asserted deficiencies for some of the taxable years in issue. As a result, these telephone companies are faced with a situation in which they may be deemed ineligible to claim accelerated depreciation and the investment tax credit even though the allowance of these benefits has already been reflected in reduced rates or refunds to utility customers. Another California utility (Southern California Gas Company) apparently has a similar problem relating to the manner in which the investment tax credit may be taken into account in establishing a utility's rate of return.

It is understood that the California Public Utility Commission has not required the use of these controversial accounting methods for any period after March 1, 1980.

Reasons for Change

Considerable controversy has arisen over the proper application of the normalization rules, principally in California. After protracted deliberations and litigation during the 1970's, the California Public Utilities Commission entered an order requiring the Pacific Telephone and Telegraph Company and General Telephone Company of California to use certain methods of accounting to measure the amount of the benefits from accelerated depreciation and the investment credit that are to be shared with the utility customers. Although no final determination has been made as to whether these methods comply with the Code's normalization requirements, the Internal Revenue Service has issued private rulings which take the position that the methods do not comply with such requirements. As a result, these telephone companies are faced with a situation in which they may be deemed ineligible to claim accelerated depreciation and the investment credit even though all or a portion of these benefits may have already been reflected in reduced rates or refunds for their customers. At least one other utility (Southern California Gas Company) apparently has a similar problem with respect to that portion of the investment credit which cannot be flowed through by utilities which are otherwise grandfathered on a flow-through method.

The committee believes that it is desirable to clarify for the future the rules relating to normalization so that no further disputes of the type which has occurred in California will arise. The committee also believes that it is appropriate to provide a special rule that would exempt utilities from the normalization requirements of present law for accounting periods that ended prior to March 1, 1980, if the utilities used accounting methods which were prescribed by an order of a public utility commission entered prior to March 13, 1980. This special rule is designed to meet a specific, one-time problem which has arisen as a result of a misapplication of the normalization rules in certain California cases. The committee does not intend that the provision of relief in this instance should be regarded as a precedent for similar relief should subsequent incidents of a similar nature occur.

Explanation of Provisions

The bill contains two amendments to the normalization rules which do not materially change the substance of present law as that law is interpreted by Treasury regulations. It also contains a special rule applicable to periods prior to March 1, 1980, which is designed to benefit Pacific Telephone and Telegraph Company (a subsidiary of American Telephone and Telegraph), General Telephone Company of California (a subsidiary of General Telephone & Electronics Corporation), and Southern California Gas Company.

Accelerated depreciation and accelerated cost recovery

The bill adds a new provision which clarifies the present definition of the normalization method of accounting under the accelerated cost recovery system and for accelerated depreciation purposes in a manner which generally follows the interpretation now contained in Treasury regulations relating to accelerated depreciation.

This added provision generally provides that normalization is not complied with if, for ratemaking purposes, a procedure or adjustment is employed which uses estimates or projections of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes unless these estimates and projections are also used in determining the other two such items and the rate base.

The Treasury also is given authority to prescribe regulations which define other procedures and adjustments which are inconsistent with normalization. This specific authority to prescribe regulations is not intended to limit the Treasury's normal authority to interpret, by regulations or otherwise, these new Code provisions or existing Code provisions relating to normalization.

This provision is intended to make it clear that California's so-called "average annual adjustment" method (and any other similar method) of making adjustments for ratemaking purposes does not comply with the normalization requirements.

The new Code provision added by the bill specifies only one manner in which the normalization rules may be violated. Thus, compliance with this provision is a necessary but not exclusive condition for eligibility for accelerated depreciation.

Investment tax credit

The bill adds a new provision to the rules relating to normalization of the investment tax credit. The new provision generally provides

that the normalization rules are not complied with if a procedure or adjustment is employed which uses an estimate or projection of the taxpayer's qualified investment for purposes of the investment tax credit unless such estimate or projection is consistent with the estimates and projections of property which are used, for ratemaking purposes, with respect to the taxpayer's depreciation expense and rate base.

The Treasury Department also is given authority to prescribe regulations which define other procedures and adjustments which are inconsistent with the requirements of the rate base method or the ratable flow-through method. This specific authority to prescribe regulations is not intended to limit the Treasury's normal authority to interpret, by regulations or otherwise, these new Code provisions or existing Code provisions relating to normalization.

This provision is intended to make it clear that California's so-called "annual adjustment" method (and any other similar method) of making adjustments for ratemaking purposes does not comply with the requirements of Code section 46(f).

The new Code provision added by the bill specifies only one manner in which the normalization rules may be violated. Thus, compliance with this provision is a necessary but not exclusive condition for eligibility for the investment tax credit.

Special rule for periods prior to March 1, 1980

The bill provides that violations of the normalization requirements of present law (and of the bill) will not result in a public utility's loss of eligibility for the investment tax credit or accelerated depreciation if (a) such violations involved the use of estimates, projections, or adjustments to the taxpayer's rate of return and (b) such estimates, projections, or adjustments only applied for any period ending prior to March 1, 1980, and were included in a qualified order.

For purposes of this special rule, a qualified order is an order of a public utility commission: (1) which was entered before March 13, 1980, (2) which used the estimates, projections, or rate of return adjustments to determine the amount of the rates to be collected by the taxpayer or the amount of a refund with respect to rates previously collected, and (3) which ordered such rates to be collected or refunds to be made (whether or not such order actually was implemented or enforced). Since the special rule would apply to rates which were determined for periods prior to March 1, 1980, an order may be a qualified order even if it requires that refunds be paid after March 1, 1980, so long as such refunds are attributable to adjustments to rates charged prior to that date.

As indicated above, this transitional rule is designed to benefit Pacific Telephone and Telegraph Company, General Telephone Company of California, and Southern California Gas Company.

Effective Date

The provisions of the bill (other than the special rule) generally apply to taxable years beginning after December 31, 1979. However, these provisions can be overridden by the special rule for periods prior to March 1, 1980.

The bill explicitly provides that, in applying the normalization rules (Code secs. 46(f) and 167(l)(3)) to taxable years beginning before January 1, 1980, no inference shall be drawn from the amendments to these rules or from the special rule. However, this no inference rule is not intended to limit the relief provided by the special rule.

Revenue Effect

The permanent changes made by section 1 of the bill will not have any revenue effect, assuming that rate orders in effect for periods ending after March 1, 1980 are incompliance with the normalization rules as to be revised by the bill.

If the orders of the California Public Utilities Commission applicable prior to March 1, 1980 to the three utilities which will be benefitted by the special rule do not comply with the current normalization rules in the Code, the special rule in section 1 of the bill will result in a revenue loss of approximately $2,200 million attributable to accounting periods prior to March 1, 1980. Approximately $117 million of this amount has been paid to the Treasury and will be the subject of claim for a refund. If the transitional rule is enacted, such amount would probably be repaid during fiscal year 1983. The remainder of the $2,200 million revenue loss generally will occur in the fiscal years in which determinations of tax liability for the affected companies would otherwise become final. Such losses would probably occur in fiscal years after 1987 because of the timing of the audit process and delays of presumed litigation.

If these orders do comply with the current normalization rules, the special rule in section 1 of the bill will not result in any revenue loss.

B. Charitable Contributions of Certain Items Created by the Taxpayer (sec. 2 of the bill and secs. 170(e) and 55 of the Code)

Present Law

The amount of charitable deduction otherwise allowable for donated property generally must be reduced by the amount of any ordinary income which the donor would have realized had the property been sold for its fair market value at the date of the contribution (sec. 170(e)). Thus, a donor of appreciated ordinary-income property (property the sale of which would not give rise to long-term capital gain) generally may deduct only the donor's basis in the property, rather than its fair market value.[1]

Since the sale of a copyright, literary, musical, or artistic composition, a letter or memorandum, or similar property by its creator results in ordinary income (sec. 1221(3)), an author, artist, etc. who donates to charity works of art, books, letters, etc., which he or she created or prepared is allowed a charitable deduction limited to his or her basis in the donated property, which typically equals the cost of the materials used in the creation of the works.

Reasons for Change

The committee concluded that an additional incentive is needed and desirable to encourage artists, authors, etc. to contribute artistic, literary, etc. compositions which they have created to charitable organizations such as museums and libraries, where they will be available to the public. Because present law provides a limited charitable deduction for such gifts, important artistic and literary works have been sold by their creators to private collectors and thus have been effectively lost to public education, scholarship, and enjoyment.

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[1] Where property in the hands of a donor is long-term capital gain property (i.e., a sale of the property on the date of contribution would produce only long-term capital gain), the donor generally is allowed an income tax deduction equal to the item's fair market value. However, in the case of donations of tangible capital gain property, the amount taken into account as a charitable contribution must be reduced by a portion of the appreciation if the use of the donated item by the donee charity is unrelated to the charity's exempt functions, or if the property is given to certain types of private foundations.

Under these rules, a collector who contributes a painting to a publicly supported museum (more than a year after purchasing it, e.g., from the artist) may deduct the fair market value of the painting at the time of the contribution. If the collector instead donated the painting to a museum which is a private foundation, or to a public charity where use of the painting would be unrelated to its exempt functions, the collector must reduce the amount of charitable deduction by 40 percent of the difference between fair market value and the purchase price.

Explanation of Provisions

Deduction for fair market value

In general

Under the bill, the amount of deduction for a charitable contribution of any literary, musical, or artistic composition, any letter or memorandum, or similar property is the property's fair market value on the date of contribution if the donated property was created by the personal efforts of the taxpayer making the contribution and if all the following conditions are satisfied:

(1) The taxpayer received a written appraisal, made within one year of the date of contribution, of the fair market value of the donated property, which appraisal is made by a person who is qualified to make such appraisal, and who also is not either the taxpayer, the donee (or any employee of the donee), or any related person (within the meaning of sec. 168(e)(4)(D));

(2) A copy of such written appraisal is attached to the taxpayer's Federal income tax return for the taxable year in which the contribution is made;

(3) The use of the donated property by the donee is related to the purpose or function constituting the basis for the donee's exemption under section 501 (or, in the case of a governmental unit, to any purpose or function described under sec. 170(c)); and

(4) The taxpayer received from the donee a written statement representing that the donee's use of the property will be in accordance with the related-use requirement.

Related-use and appraisal requirements

Under the related-use requirement of the bill, if (for example) an artist contributes his or her painting to a museum and the museum displays the painting for viewing by the public, such use by the museum would satisfy the requirement. On the other hand, if the museum sold the donated painting rather than displaying it as part of its art collection, the use of the property would not satisfy the requirement, and the donor's charitable deduction accordingly would be limited to his or her basis in the painting, regardless of the museum's use of the proceeds from the sale of the donated property.

While the special deduction rule under the bill is not available if the donor fails to obtain from the donee the written statement (described above) concerning the related-use requirement, the receipt of such statement does not itself establish that in fact the related-use requirement has been met, i.e., that the donated property is in fact only put to a related use by the donee.

The satisfaction by a taxpayer of the written appraisal requirement in the bill does not give rise to any presumption as to the correctness of the valuation in the appraisal. While the bill permits the required appraisal to be made within one year of the date of the contribution, the deduction is allowed for the fair market value of the art work, etc.

at the date such contribution is made, not at the date (if different) on which the required appraisal was made.

Exception

The bill does not change the application of the present-law deduction rules in the case of charitable contributions of any letter, memorandum, or similar property which was written, prepared, or produced by or for any Federal, State, or local government officer or employee if such property arose out of, or was related to, the performance of that individual's duties as such officer or employee.

Minimum tax

The bill also provides that any amount deductible under the regular income tax as a result of the changes made by the bill to the charitable deduction is not deductible under the alternative minimum tax for individuals; that is, the charitable deduction for purposes of the alternative minimum tax is limited to the taxpayer's basis in the property. Likewise, any charitable deduction carryover attributable to amounts made deductible under the regular income tax by the bill (i.e., the excess of fair market value over basis) are not deductible under the alternative minimum tax for individuals.

Effective Date

The amendments made by section 2 of the bill apply to contributions made after December 31, 1982, in taxable years ending after that date.

Revenue Effect

The provisions of section 2 of the bill are estimated to reduce budget receipts by $5 million in fiscal year 1983 and by $15 million annually in subsequent fiscal years.

C. Decrease in Holding Period Required for Long-Term Capital Gain Treatment (sec. 3 of the bill and sec. 1222 of the Code)

Present Law

Gains or losses on sales or exchanges of capital assets held for more than 12 months are considered long-term capital gains or losses (sec. 1222). For noncorporate taxpayers, only 40 percent of net long-term capital gains are included in taxable income, while 100 percent of net short-term gains are included. However, 100 percent of net short-term losses (up to $3,000) are deductible, while only 50 percent of net long-term losses (up to $3,000) may be deducted.

For corporate taxpayers, net long-term capital gains are subject to an elective, alternative tax rate of 28 percent, while net short-term gains are taxed at ordinary corporate rates.

Reasons for Change

The differential tax treatment of short-term and long-term transactions creates incentives for investors not to realize short-term gains. Studies of capital asset sales data confirm that investors are "locked-in" to investments because they do not desire to realize short-term gains. This reduces capital market efficiency because investors hold assets longer than they otherwise might in the absence of tax considerations. By reducing the capital gains holding period from 12 to 6 months, the committee believes that the lock-in effect and its adverse impact on capital market efficiency will be reduced. Prior to 1977, the holding period was 6 months.

Explanation of Provision

The holding period for determining whether a gain or loss on the sale or exchange of a capital asset or certain business property is long-term or short-term is reduced from 1 year to 6 months. Thus, property held for more than 6 months will be eligible for long-term capital gain or loss treatment.

The bill also modifies the treatment of straddles in stock options. Under present law (sec. 1092(d)), certain straddles in listed stock options are exempt from the loss deferral, short sale, and wash sale rules of section 1092 if one of the options in the straddle is of a type with respect to which the maximum period during which such option may be exercised is less than the capital gains holding period. Currently, listed stock options generally expire within 9 months and the capital gains holding period is one year; therefore, all listed stock options are generally exempt from section 1092. Shortening the holding period to 6 months, however, would make listed stock option straddles subject to the loss deferral, wash sale, and short sale rules and could conceivably

open up the possibility of using stock option straddles to convert short-term capital gain into long-term capital gain.

To deal with these problems, the bill makes several changes to the stock option exemption in section 1092. First, it provides that listed stock options are generally exempt from the loss deferral, wash sale, and short sale rules if none of the positions in the straddle can produce long-term capital gain or loss. In the case of syndicates, the straddles are exempt only if none of the positions can produce either long-term capital gain or loss or ordinary income or loss. For a stock option owned by a dealer to be exempt, the option must also be entered into in the normal course of the dealer's trade or business (unless the option is held in the dealer's investment account). No inference is intended about the circumstances under which stock options are capital assets under existing law.

The bill also provides that gain from the cutting of timber is to be treated as long-term capital gain only if the timber has been held for more than 6 months and was held on the first day of the taxpayer's taxable year.

The bill makes a variety of other conforming changes to the Code.

Effective Date

The provision generally applies to sales or exchanges made after June 30, 1982. (Thus, in the case of an installment sale made prior to July 1, 1982, of a capital asset held more than 6 months, but less than one year, all payments received will continue to be treated as short-term capital gain.) The new holding period does not apply to assets on which the taxpayer realizes capital losses if those assets were held by the taxpayer on June 30, 1982. The changes relating to stock option straddles apply to positions held on June 30, 1982.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by $169 million in 1983, $244 million in 1984, $244 million in 1985, $261 million in 1986, and $275 million in 1987.

III. COSTS OF CARRYING OUT THE BILL AND VOTE OF THE COMMITTEE IN REPORTING THE BILL

Budget Effects

In compliance with paragraph 11(a) of Rule XXVI of the Standing Rules of the Senate, the following statement is made relative to the budget effects of H.R. 1524, as reported.

Budget receipts

The table below summarizes the estimates of the effects on budget receipts of the provisions of the bill for fiscal years 1983–1987:

Section 1

The permanent changes made by section 1 of the bill will not have any revenue effect, assuming that rate orders in effect for periods ending after March 1, 1980 are in compliance with the normalization rules as to be revised by the bill.

If the orders of the California Public Utilities Commission applicable prior to March 1, 1980 to the three utilities which will be benefitted by the special rule do not comply with the current normalization rules in the Code, the special rule in section 1 of the bill will result in a revenue loss of approximately $2,200 million attributable to accounting periods prior to March 1, 1980. Approximately $117 million of this amount has been paid to the Treasury and will be the subject of claim for a refund. If the transitional rule is enacted, such amount would probably be repaid during fiscal year 1983. The remainder of the $2,200 million revenue loss generally will occur in the fiscal years in which determinations of tax liability for the affected companies would otherwise become final. Such losses would probably occur in fiscal years after 1987 because of the timing of the audit process and delays of presumed litigation.

If these orders do comply with the current normalization rules, the special rule in section 1 of the bill will not result in any revenue loss.

Section 2

The provisions of section 2 of the bill are estimated to reduce budget receipts by $5 million in fiscal year 1983 and by $15 million annually in subsequent fiscal years.

Section 3

The provisions of section 3 of the bill are estimated to reduce fiscal year budget receipts by $169 million in 1983, $244 million in 1984, $244 million in 1985, $261 million in 1986, and $275 million in 1987.

The Treasury Department agrees with this statement.

Budget outlays

The bill involves no budget outlays.

Vote of the Committee

In compliance with paragraph 7(c) of Rule XXVI of the Standing Rules of the Senate, the following statement is made relative to the vote by the committee on the motion to report the bill. H.R. 1524, as amended, was ordered favorably reported by voice vote.

IV. REGULATORY IMPACT OF THE BILL AND OTHER MATTERS TO BE DISCUSSED UNDER SENATE RULES

Regulatory Impact

Pursuant to paragraph 11(b) of Rule XXVI of the Standing Rules of the Senate, the committee makes the following statement concerning the regulatory impact that might be incurred in carrying out the provisions of H.R. 1524, as reported.

Numbers of individuals and businesses who would be regulated

The bill does not involve new or expanded regulation of individuals or businesses.

Economic impact of regulation on individuals, consumers, and businesses

The provisions in section 1 of the bill (relating to the normalization method for public utility property) will make it easier for affected persons to understand and comply with the requirements applicable to that method. The provisions in section 2 of the bill (relating to charitable contributions of certain items created by the taxpayers) will encourage artists, authors, etc. to contribute their artistic, literary, etc. works to charitable organizations such as museums and libraries, where they will be available to the public. The provisions in section 3 of the bill (decrease in holding period required for long-term capital gain treatment) will reduce the "lock-in" effect on investments and its adverse impact on capital market efficiency.

Impact on personal privacy

The bill does not relate to the personal privacy of individuals.

Determination of the amount of paperwork

The bill will involve little additional paperwork for taxpayers. Under section 2 of the bill, an artist, author, etc. who makes a charitable contribution of property which he or she created must obtain a written appraisal of the fair market value of the donated property, and attach a copy of the appraisal to his or her Federal income tax return, in order for the contribution to be eligible for the special deduction rule added by the bill.

Other Matters

Consultation with Congressional Budget Office on budget estimates

In accordance with section 403 of the Budget Act, the committee advises that the Director of the Congressional Budget Office has examined the committee's budget estimates of the provisions of the bill (as shown in Section III of this report) and agrees with the

methodology used and the committee's budget estimates. The Director submitted the following statement:

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, D.C.

Hon. ROBERT DOLE,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: In accordance with the Budget Act, the Congressional Budget Office has examined H.R. 1524, as amended by the Committee on Finance. The original bill as passed by the House of Representatives modifies the normalization rules for the investment tax credit and accelerated depreciation for public utility property. The special transition rule is designed to benefit Pacific Telephone and Telegraph Company, General Telephone Company of California and Southern California Gas Company. The Committee on Finance approved the bill with two amendments dealing with charitable contributions of certain items and a decrease in the holding period for long-term capital gains.

This bill does not provide any new budget authority or any new tax expenditures, but all three provisions increase tax expenditures.

In accordance with Section 403 of the Budget Act, the Congressional Budget Office has reviewed the revenue estimates provided by the staff of the Joint Committee on Taxation, and agrees with the methodology used and the resulting estimates. It is estimated that the provisions contained in the bill will reduce budget receipts and increase tax expenditures by the following amounts:

Fiscal year:	*Millions*
1983	—$291
1984	—259
1985	—259
1986	—276
1987	—290

The individual revenue estimates of the three provisions of the bill are outlined in the attached table. The provisions that are starred (*) represent increased tax expenditures.

Sincerely,

ALICE M. RIVLIN, *Director.*

ESTIMATED REVENUE EFFECTS OF H.R. 1524, NORMALIZATION METHOD FOR PUBLIC UTILITY PROPERTY

[Fiscal years, in millions of dollars]

	1983	1984	1985	1986	1987
Normalization methods for public utility property [1]	—117				
Charitable contributions of certain items [1]	—5	—15	—15	—15	—15
Decrease in the holding period for long-term capital gains [1]	—169	—244	—244	—261	—275
Total	—291	—259	—259	—276	—290

[1] Tax expenditures.

New budget authority

In compliance with section 308(a)(1) of the Budget Act, and after consultation with the Director of the Congressional Budget Office, the committee states that the changes made to existing law by the bill involve no new budget authority.

Tax expenditures

In compliance with section 308(a)(2) of the Budget Act with respect to tax expenditures, and after consultation with the Director of the Congressional Budget Office, the committee states that the changes made to existing law by the bill involve no new tax expenditures, and that the changes to existing law made by sections 1, 2, and 3 of the bill involve increased tax expenditures. The estimated effects on budget receipts of tax expenditure changes is shown in Section III of this report.

V. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In the opinion of the committee, it is necessary, in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of Rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the provisions of H.R. 1524, as reported by the committee).

VI. ADDITIONAL VIEWS OF SENATOR ARMSTRONG

An amendment to this tax bill raises a number of important policy issues that deserve careful consideration by Congress.

Federal tax law includes provisions granting investment tax credits and accelerated depreciation to the nation's utilities. This policy is based on recognition that the nation's utilities are having increasing difficulty in obtaining sufficient capital to finance future and necessary plant expansion. Also included in tax law is a provision that, in essence, denies these tax benefits to utilities if the tax savings are immediately passed on to ratepayers in the form of lower utility bills. In doing so, Congress made the policy decision that federal tax legislation designed to encourage capital formation in the utility industry should not be thwarted by passing on the savings to consumers directly rather than using the incentive as intended to improve the utility's ability to provide service in the future. Clearly, doing so would cannibalize capital, and frustrate the intent of Congress.

All utilities in 49 states have, to the knowledge of the Joint Tax Committee, complied with the provisions of this law. However, the state of California, at the order of the California Supreme Court, and three utilities operating within the state have not done so. Let me hasten to add, however, that the utilities involved are not responsible for flaunting federal tax law. They are caught in a crossfire between two government agencies. California with the action of its Supreme Court, has acted to keep the utilities from abiding by the law, while the Internal Revenue Service insists the companies follow Congressional intent.

Here are the facts as I understand them. The California Public Utilities Commission ordered its utilities to pass through the savings generated from tax benefits provided under federal tax law. The utilities complied. By doing so, they risk losing the tax benefits—which with interest will accumulate to about $2.3 billion—they received from the federal tax law.

The tax benefits have already been received by the utilities . . . and the utilities have since been ordered to pass them through to their consumers. Since the IRS believes they should not be permitted to do so, they are now filing notices of tax deficiencies against the utilities involved.

Included in this bill is a provision which, in essence, permits the three affected utilities to keep the tax benefits even though they did not comply with the intent of the law.

I sympathize with the plight of the utilities. But implicit in this legislation is the notion that "California, we let you get away with it once, but we are not going to let you do it again."

Here are some issues Congress should consider.

First, is this legislation necessary? The issue could be litigated . . . in fact it should so as to resolve the basic issue of whether the Internal Revenue Service is correct in its interpretation of the federal law.

Second, should the state of California be permitted to be the only state not following the intent of federal tax law, as interpreted by the Internal Revenue Service?

Third, is this a precedent Congress wants to set? Will legislation like this open the door to willful and pervasive efforts by states not to follow and honor federal tax law?

Since there has been little real opportunity to focus on this bill, I am reluctant to approve this legislation at this time. It seems to have impact on federal revenues . . . about $2.3 billion . . . and raises questions of basic fairness since 49 other states have evidently complied with the law. Such issues deserve careful study. We should not rush to judgment.

WILLIAM L. ARMSTRONG.

VII. ADDITIONAL VIEWS OF SENATOR LONG

Because I support the provisions of H.R. 1524 as it passed the House, I voted to order the bill favorably reported. But I am opposed to the committee amendment relating to the tax treatment of artists' charitable donations.

This amendment would allow artists, composers, and authors to deduct the full retail value of art and manuscripts donated to charity, notwithstanding the usual anti-abuse rule limiting the deduction for inventory items to the donor's cost basis.

The amount of the deduction would not be offset for the commissions usually incurred when he sells his work through a gallery; these commissions are frequently in the range of 50 percent. As a result, the amendment would allow high-income individuals to have as much or more after-tax income from gifts of their work as they would have if they had sold their work. For an artist, composer, or author in this position, it would make donations a profitable enterprise and would take the charity out of charitable giving. This amounts to a Federal art and manuscript purchase program, with the Government in effect paying the full retail price for works selected by the artist, composer, or author and donated to charities selected by him.

RUSSEL B. LONG.

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